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No. 95-____

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In the Supreme Court of the United States

OCTOBER TERM, 1995

PAUL RUSSO, BARBARA HOSMAN and
WILLIAM PETROKANSKY,

Petitioners,

v.

UNITED STATES OF AMERICA

On Petition For Writ Of Certiorari To
The United States Court Of Appeals
For The Second Circuit

PETITION FOR WRIT OF CERTIORARI

Daniel Richman, Esq.
140 West 62nd Street
New York, N.Y. 10023
(212) 636-6934

Attorney for Petitioners

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QUESTION PRESENTED

May a finding of manipulation, under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, be based upon a defendant's purchases of stock on the open market, where he made no misrepresentations to his trading parties or the market, and the only fraud lay in the manner in which he obtained the funds to make those purchases?

TABLE OF CONTENTS

	Page
QUESTION PRESENTED	i
TABLE OF CONTENTS	ii
TABLE OF AUTHORITIES	iii
PARTIES	1
OPINION BELOW	1
JURISDICTION	1
STATUTES AND RULES INVOLVED	1
STATEMENT	3
REASONS FOR GRANTING THE PETITION	8
CONCLUSION	22
APPENDIX	
United States v. Russo et al., 74 F.3d 1383	A-1

TABLE OF AUTHORITIES
CASES

Angelastro v. Prudential-Bache Securities
764 F.2d 939 (3d Cir.), cert. denied,
474 U.S. 935 (1985) 12

Blue Chip Stamps v. Manor Drug Stores,
421 U.S. 723 (1975) 17, 21

Central Bank of Denver v.
First Interstate Bank of Denver,
114 S.Ct. 1439 (1994) 17, 21

Chemical Bank v. Arthur Anderson & Co.,
726 F.2d 930 (2d Cir.), cert. denied,
469 U.S. 884 (1984) 12, 16

Chiarella v. United States,
445 U.S. 222 (1980) 8, 18-21

Crane v. Westinghouse Air Brake Co.,
419 F.2d 787 (2d Cir. 1969),
cert. denied, 400 U.S. 822 (1970) . . 14

Deutschman v. Beneficial Corp.,
841 F.2d 502 (3rd Cir. 1988),
cert. denied, 490 U.S. 1114 (1989) . 19

Dirks v. S.E.C., 463 U.S. 646 (1983) 19

Edward J. Mawod & Co. v. S.E.C.,
591 F.2d 588 (10th Cir. 1979) 14

Gurwara v. Lyphomed, Inc.,
937 F.2d 380 (7th Cir. 1991) 12

HMCA (Carolina), Inc. v. Soler-Zapata,
778 F. Supp. 1234 (D.P.R. 1991) . . . 13

Hunt v. Robinson, 852 F.2d 786
(4th Cir. 1988) 12

Paracor Finance, Inc v. General Electric
Capital Corp., __ F.3d __ (9th Cir.
1996) (No. 94-15633) 19

Pin v. Texaco, Inc., 793 F.2d 1448
(5th Cir. 1986) 10

Roeder v. Alpha Industries, 814 F.2d 22
(1st Cir. 1987) 19

Rubin v. United States,
449 U.S. 424 (1981) 13, 16

S.E.C. v. Cherif, 933 F.2d 403
(7th Cir. 1991), cert. denied,
502 U.S. 1071 (1992) 15

S.E.C. v. Clark, 915 F.2d 439
(9th Cir. 1990) 15

S.E.C. v. Kimmes, 799 F. Supp. 852
(N.D.Ill. 1992), aff'd, 997 F.2d 287
(7th Cir. 1993) 14

S.E.C. v. Rana Research, Inc.,
8 F.3d 1358 (9th Cir. 1993) 16

Santa Fe Industries, Inc. v. Green,
430 U.S. 462 (1977) 10

Schlick v. Penn-Dixie Cement Corp.,
507 F.2d 374 (2d Cir. 1974),
cert. denied, 421 U.S. 976 (1975) . . 14

Schreiber v. Burlington Northern, Inc.
472 U.S. 1 (1985) 9-10, 20

Superintendent of Insurance v. Bankers Life & Casualty Co., 404 U.S. 6 (1971) 12

United States v. Blitz, 533 F.2d 1329 (2d Cir.), cert. denied, 429 U.S. 819 (1976) 14

United States v. Bryan, 58 F.3d 933 (4th Cir. 1995) 15, 19

United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), affirmed by an equally divided Court, 484 U.S. 19 (1987) 15

United States v. Charney, 537 F.2d 341 (9th Cir.), cert. denied, 429 U.S. 1000 (1976) 14, 19

United States v. Chestman, 947 F.2d 551 (2d Cir. 1991), cert. denied, 503 U.S. 1004 (1992) 15

United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983) 15

United States v. Regan, 937 F.2d 823 (2d Cir. 1991), cert. denied, 504 U.S. 940 (1992) 13, 20

United States v. Stein, 456 F.2d 844 (2d Cir.), cert. denied, 408 U.S. 922 (1972) 14

VT Investors v. R & D Funding Inc., 733 F. Supp. 823 (D.N.J. 1990) . . . 13

STATUTES

15 U.S.C. §78j(b) . . . . . passim

15 U.S.C. §§ 78ff 4

18 U.S.C. § 371 3

18 U.S.C. § 1341 3

28 U.S.C. § 1254(1) 1

17 C.F.R. § 240.10b-5 (1995) . . passim

MISCELLANEOUS

Daniel R. Fischel & David J. Ross, Should the Law Prohibit "Manipulation" in Financial Markets?, 105 Harv. L. Rev. 503 10

2 THOMAS L. HAZAN, THE LAW OF SECURITIES REGULATION 109 (2d Ed. 1990) 12

PARTIES

Paul Russo, Barbara Hosman, and William Petrokansky petition for a writ of certiorari to review the judgement of the United States Court of Appeals for the Second Circuit in this case.

OPINION BELOW

The opinion in the court of appeals (App., infra, A-1) is reported at 74 F.3d 1383.

JURISDICTION

The judgment of the court of appeals was entered on January 11, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. § 1254(1).

STATUTES AND RULES INVOLVED

Section 10(b) of the Securities Exchange Act, 15 U.S.C. § 78j(b) (1994), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange ...
>
> (b) [t]o use or employ, in connection with the purchase or sale of any security registered on a national securities

exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the SEC may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5, 17 C.F.R. § 240.10b-5 (1995), provides:

> Employment of manipulative and deceptive devices. It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person,
>
> in connection with the purchase or sale of any security.

STATEMENT

1. On December 11, 1991, a grand jury sitting in the United States District Court for the Eastern District of New York returned a 19-count indictment against Paul Russo, Barbara Hosman, and William Petrokansky, charging offenses arising out of their activities in 1986-87 at Kureen & Cooper ("K&C"), a New York City securities brokage firm owned by Mr. Russo. Count One of the indictment charged all three defendants with conspiracy to commit violations of Rule 10b-5 of the Securities and Exchange Commission and the mail fraud statute, in violation of 18 U.S.C. § 371. One of the goals of the conspiracy was said to be a scheme to manipulate the prices of two stocks: Lopat Industries, Inc. ("Lopat") and E.A.S. Technologies, Inc. ("EAS"). In 1985 and 1986, K&C had underwritten the initial public offerings ("IPOs") and thereafter acted as one of the market makers for both stocks, which were traded on the over-the-counter NASDAQ market. The indictment charged that there were three different aspects to this manipulation scheme: (1) "[W]hen large quantities of Lopat and EAS stock were offered for sale to the public, the defendants caused K&C to purchase the stock rather than let the oversupply of the stock depress its market price;" (2) the defendants made unauthorized EAS and Lopat trades in K&C customers' accounts, and (3) "parked" EAS and Lopat stock in K&C customers' accounts. Counts Two through Seventeen charged mail fraud, in violation of 18 U.S.C. § 1341, and Counts Eighteen and Nineteen charged securities

fraud in violation of 15 U.S.C. §§ 78j(b) and 78ff, all based on the same scheme to manipulate the prices of Lopat and EAS shares.

2. The jury trial began on January 4, 1994, and ended two and a half months later. In it, the government introduced the evidence to support the so-called "short-sales prong" of its manipulation case. As one of the market makers for Lopat and EAS shares, K&C had to stand ready to purchase shares of those stocks when offered for sale on open market, and had large blocks of these stocks in its inventory. When these stocks did not perform well, and the number of shares offered for sale rose, K&C was put at substantial financial risk. Because the firm was thinly capitalized, it could not buy up shares and hold them, and instead would have to sell them off before the end of each day. (App., infra, A-5). To solve this problem, according to the government's evidence, Mr. Russo devised a scheme to keep Lopat and EAS shares off the market. Part of this scheme involved unauthorized purchases of those shares for K&C customers, and the "parking" of shares in customer accounts, making it appear that the shares were no longer in K&C's own inventory, and thus avoiding a violation of net capital rules. Another part of the scheme involved purchases that K&C made on the open market with credits it had obtained from its clearing broker, Evans & Co. ("Evans").

As K&C's clearing broker, Evans processed all the trading orders that K&C placed on its own behalf and on behalf of

its customers. Some of the trades that K&C asked Evans to execute were short sales. In a short sale, a seller sells stock he does not own, but borrows for that purpose. He pays a fee for the loan, and eventually must "cover" the sale by returning an equivalent amount of stock to the broker. Under Federal Reserve Board margin rules, a seller must put up at least half the value of the stock he sells short, and any proceeds from his sale are frozen until he covers it. (App., infra, A-8). K&C's clearing agreement with Evans did not permit K&C to make short sales, but, after a coding error, K&C realized that it could do so without being held to the margin requirements. By miscoding future orders, Mr. Russo was able to generate large cash credits in K&C's account with Evans through short sales of high value stocks like MCI, Apple Computer, and Dime Savings Bank. Tr. 500, 646, 1895. He used some these credits to meet K&C's payroll expenses, Tr. 418. And he used some of the credits to purchase Lopat and EAS shares from sellers who were offering them during the period when K&C was trying to maintain the prices of these stocks against downward pressures.

Before summations, defendants asked the district court to instruct the jury that "a trade is not manipulative if that trade is done at arm's length on the open market, even if it is done solely to cause the price of the stock to trade at an 'artificially high level.'" Defendants' Jury Instruction Request No. 9. The court refused to grant this request.

In its summation, the government argued that the short sales were a "device used to carry out manipulation," Tr. 4075, the use of such a "device" being an element of a manipulation charge under Section 10(b) and Rule 10b-5. And in its instructions, the district court made clear that the jury could find manipulation, and thus convict on the conspiracy charge and all the mail fraud and securities fraud charges, simply by finding that the defendants had engaged in the short sales in the high-value stocks in order to fund their purchases of EAS and Lopat in the open market, so as to keep the prices of those stocks from falling. Tr. 4640, 4648-49, 4659, 4669. The jury was also charged that manipulation verdict could also be based on a finding that the defendants had used unauthorized trading and stock parking with an intent to artificially affect the prices of EAS and Lopat. However, the district court did not require the jury to specify the basis of its verdict.

At the conclusion of the trial, the jury found Mr. Russo and Ms. Hosman guilty on all counts, and Mr. Petrokansky guilty on five counts of mail fraud and two counts of securities fraud; the district court declared a mistrial as to the remaining counts against Mr. Petrokansky. Thereafter, the district court sentenced Mr. Russo to 18 months' imprisonment, to be followed by 5 years' probation, and endorsed an agreement between Mr. Russo and the government establishing a restitution fund. The court sentenced Ms. Hosman to 6 months' imprisonment and 5 years' probation, and

sentenced Mr. Petrokansky to 12 months' imprisonment and 5 years' probation.

3. On appeal, defendants never denied that K&C's alleged scheme to obtain credits from Evans by not disclosing its improper short sales in high value stock could be charged as some sort of separate fraud. Nor did defendants deny that a finding of manipulation could be based on the unauthorized trading and stock parks that K&C allegedly did in order to keep shares of EAS and Lopat off the market. Rather, defendants contended that the government's short sale theory of manipulation had been illegal. The fraud on Evans had not been "in connection" with defendants' purchases of EAS and Lopat, within the meaning of Section 10(b). Moreover, defendants could not be said to have breached any general duty to the market when they bought up the shares of EAS and Lopat that willing sellers were offering.

The court of appeals affirmed defendants' convictions, finding that "the fraudulent short sales made for the express purpose of financing [defendants'] stock kiting scheme served as a fraud on the market for Lopat and EAS stock," and that therefore "the short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Section 10(b) and Rule 10b-5. (App., infra, A-18). The court reasoned: "While the short sales did not affect the markets for Lopat and EAS through actual trading, they enabled K&C to create a false impression of demand

for the stock and to shield prices from the realities of the market." (Id. at A-16). The court went on explain that defendants "had a duty to disclose their deceit to the market," since unlike the defendant in Chiarella v. United States, 445 U.S. 222 (1980), they had sought "to benefit personally from an illegal self-created scheme." (App., infra, A-17).

The court of appeals also rejected defendants' other claims, notably those arguing failure to charge defense theory, misuse of expert testimony, prosecutorial misconduct in summation, and the insufficiency of the evidence as to Hosman and Petrokansky.

REASONS FOR GRANTING THE PETITION

Recognizing that manipulation can not be charged under Section 10(b) and Rule 10b-5 without an element of deception, the court of appeals here supplied two intertwined rationales: (1) defendants funded their open-market purchases of Lopat and EAS by deceiving Evans into letting K&C make improper short sales in unrelated stocks, and (2) defendants were under some duty to inform the market that the funds K&C was using to purchase Lopat and EAS shares had come from its fraud on Evans. The first of these rationales stretches the "in connection" requirement of section 10(b) to its breaking point, and exposes securities traders to criminal and civil liability under the securities laws whenever their open-market purchases are said to be funded by any fraud on anyone

in any context. The second rationale imposes a general duty of disclosure to the market that similarly would expand the scope of liability under section 10(b) far beyond what the words of that provision will reasonably bear.

Both of these rationales are flatly inconsistent with this Court's holdings, and in conflict with settled law in other circuits. Moreover, the two rationales threaten to open the floodgates to improper civil suits by eviscerating two doctrines that federal courts have traditionally used to prevent private litigants from transforming ordinary business disputes into claims under the securities laws. The disruption may be particularly great because of the volume and importance of securities litigation in the Second Circuit. Because the correct resolution of the question in this case is needed to maintain the appropriate scope of liability under the securities laws, and resolve a conflict in the circuits, this Court's review is warranted.

1. In Schreiber v. Burlington Northern, Inc., 472 U.S. 1 (1985) -- a case cited nowhere in the court of appeals' opinion -- this Court held that even if conduct affects the market price of a stock, it is not manipulation absent either misrepresentations or non-disclosure under circumstances where there is an obligation to disclose. Id. at 12. Although Schreiber involved a claim under section 14(e) of the Securities and Exchange Act of 1934, not

section 10(b), the Court made clear that the term "manipulative" has the same meaning under both provisions. Id. at 7-8; see also Pin v. Texaco, Inc., 793 F.2d 1448 (5th Cir. 1986) (sanctions imposed under Fed. R. Civ. P. 11 for civil complaint alleging manipulation under section 10(b) without alleging misrepresentation or deception). The Court's concern in Schreiber also extended beyond the context of section 14: To interpret "manipulative" as meaning something other than misrepresentation or nondisclosure would not only go beyond the philosophy of disclosure that lies at "the core" of the Securities Exchange Act, 472 U.S. at 8, but would set courts adrift, allowing judges to "read the term 'manipulative' with their own sense of what constitutes 'unfair' or 'artificial' conduct,'" id. at 12; see Santa Fe Industries, Inc. v. Green, 430 U.S. 462, 476-77 (1977); see also Daniel R. Fischel & David J. Ross, Should the Law Prohibit "Manipulation" in Financial Markets?, 105 Harv. L. Rev. 503, 522-23 (1991) (discussing social costs of a prohibition on manipulation that turns "entirely on the state of mind of the trader").

This Court's careful effort to prevent vague claims or findings of "manipulation," by demanding that deceit be shown, would be for naught if courts could disregard the "in connection" requirement of section 10(b) and find the requisite deceit simply by pointing to the means by which a someone purchasing stock on the open market had obtained his funds, in the absence of any

misrepresentations to trading partners or the market at large. But that is precisely what the court of appeals did here.

On appeal, defendants argued that to find a "connection" under section 10(b) between K&C's allegedly deceitful dealings with its clearing broker and its open-market purchases of unrelated stocks would be analogous to finding a connection between an investor's fraudulent home loan application and the stock purchases that he made with loan's proceeds -- a rule that would radically expand the scope of securities fraud to cover every collateral fraud that helped fund a stock purchase. The court of appeals sought to distinguish this analogy by pointing to K&C's status as a market maker, reasoning that the firm "could not have continued to make this market without the money generated by the short sales." (App., infra, A-17). But by this rationale, a market maker -- and K&C was only one of twenty market makers for EAS and Lopat stock, Tr. 3746-47; DX J, M -- or indeed any purchaser of thinly traded stock would be liable for manipulation even under the home loan fraud scenario.

The court of appeals' relaxation of the "in connection" requirement in this case is in conflict with caselaw in other circuits. In Superintendent of Insurance v. Bankers Life & Cas. Co., 404 U.S. 6 (1971), this Court instructed that section 10(b) "be read flexibly, not technically and restrictively," id. at 12, and held that where the consideration

offered to an investor was in effect worthless, the deception was sufficiently "in connection" with a securities sale to support a civil action under that provision. However, Superintendent of Insurance did not hold that any fraud remotely connected to a securities sale will satisfy the "in connection" requirement, and the lower courts have not read it to say so. See 2 THOMAS L. HAZAN, THE LAW OF SECURITIES REGULATION 109 (2d Ed. 1990) ("The 'in connection' requirement will not support a rule 10b-5 action for simply any wrongdoing that just happens to involve securities."). Indeed, there is considerable authority in the lower courts holding that the requisite "connection" is not present where -- as in this case -- the alleged misrepresentations did not relate "to the value of the involved security or the consideration offered for it." Gurwara v. Lyphomed, Inc., 937 F.2d 380, 382-83 (7th Cir. 1991); see Hunt v. Robinson, 852 F.2d 786, 787 (4th Cir. 1988) (no "connection" where plaintiff suing for fraudulent nonconveyance of stock "alleged no misrepresentation of the value of the stock which was to be conveyed"); Angelastro v. Prudential-Bache Securities, Inc., 764 F.2d 939, 944 (3d Cir.) ("in connection" language requires "some causal connection between the alleged misrepresentation and the harm incurred when a security is purchased or sold"), cert. denied, 474 U.S. 935 (1985); Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 943 (2d Cir.) (Friendly, J.)("'misrepresentations or omissions involved in a securities transaction but not pertaining to the

securities themselves'" cannot "form the basis of" a violation of section 10(b) and Rule 10b-5), cert. denied, 469 U.S. 884 (1984) (quoting Rubin v. United States, 449 U.S. 424, 429 n.6 (1981)); HMCA (Carolina), Inc. v. Soler-Zapata, 778 F. Supp. 1234, 1241 (D.P.R. 1991) (no "connection" where "alleged fraudulent misrepresentations [were] totally unrelated to the value of the [stock], that company's assets, or any other characteristic of the securities themselves"); VT Investors v. R & D Funding Inc., 733 F. Supp. 823, 831 (D.N.J. 1990) (no "connection" where "misrepresentations [had] no connection to any conceivable loss suffered from" the securities transaction).

The degree to which the court of appeals stretched the "in connection" requirement is highlighted by comparing the facts found sufficient for manipulation liability here with those in other manipulation cases, all of which involved allegations or proof of misleading statements or conduct designed to convey false information to the market about the value of the manipulated stock. See United States v. Regan, 937 F.2d 823, 829 (2d Cir. 1991) (upholding manipulation conviction in connection with efforts by investment firm to counter company's efforts to "levitate" the price of its stock, court focused on the "devious means" that investment firm had used "to depress the price" of that stock, which included the concealment of the fact that the firm was "the moving party behind the entire deal."), cert. denied, 504 U.S. 940 (1992); United

States v. Charney, 537 F.2d 341, 350 (9th Cir.) (manipulation charges properly brought against persons who, after making an offer to purchase a company's assets, had induced others to sell its shares by secretly guaranteeing a minimum amount, thereby depressing the price of the stock and thereby inducing the company's directors to accept the asset-purchase offer; "object and effect" of scheme was to "deceiv[] shareholders and directors" of the target company), cert. denied, 429 U.S. 1000 (1976); Schlick v. Penn-Dixie Cement Corp., 507 F.2d 374, 377, 381 (2d Cir. 1974) (manipulation scheme includes "omissions and misstatements" in defendant's proxy statement, which misled as to the "manner in which [defendant] had inflated the value of its shares), cert. denied, 421 U.S. 976 (1975); Crane v. Westinghouse Air Brake Co., 419 F.2d 787, 793 (2d Cir. 1969) (defendant's "extraordinary buying here, coupled with its large secret sales off the market, inevitably distorted the market picture and deceived public investors."), cert. denied, 400 U.S. 822 (1970); see also Edward J. Mawod & Co. v. S.E.C., 591 F.2d 588, 595 (10th Cir. 1979) (use of wash sales and matched orders); United States v. Blitz, 533 F.2d 1329, 1338 (2d Cir.) (fraudulent promises of quick profits made by salesmen to friends and customers), cert. denied, 429 U.S. 819 (1976); United States v. Stein, 456 F.2d 844 (2d Cir.) (use of nominees and payment of secret compensation to brokers), cert. denied, 408 U.S. 922 (1972); S.E.C. v. Kimmes, 799 F. Supp. 852 (N.D.Ill. 1992) (use of captive or cooperative brokerage companies, nominee

accounts, false public filings, false press releases), aff'd, 997 F.2d 287 (7th Cir. 1993).

The court of appeals' expansion of the section 10(b)'s "in connection" requirement in this case reflects a general tendency of the Second Circuit to interpret that provision broadly, a tendency that the Fourth Circuit recently challenged in the context of insider trading liability. In a long line of cases, the Second Circuit -- followed by the Seventh and Ninth Circuits -- has held that if a person trades on the basis of "material nonpublic information in breach of a fiduciary duty or similar relationship of trust and confidence," United States v. Chestman, 947 F.2d 551, 566 (2d Cir. 1991) (en banc), cert. denied, 503 U.S. 1004 (1992), the fraud is sufficiently "in connection" with the securities trade to support liability under section 10(b), notwithstanding the fact that the fraud may have been on the defendant's employer, and not any buyer or seller of securities. See United States v. Newman, 664 F.2d 12 (2d Cir. 1981), aff'd after remand, 722 F.2d 729 (2d Cir.), cert. denied, 464 U.S. 863 (1983); see also S.E.C. v. Cherif, 933 F.2d 403 (7th Cir. 1991), cert. denied, 502 U.S. 1071 (1992); S.E.C. v. Clark, 915 F.2d 439 (9th Cir. 1990). Presented with an application of the Second Circuit's misappropriation theory in United States v. Carpenter, 791 F.2d 1024 (2d Cir. 1986), this Court affirmed by an equally divided Court, 484 U.S. 19 (1987). In United States v. Bryan, 58

F.3d 933 (4th Cir. 1995), however, the Fourth Circuit squarely rejected this misappropriation theory of securities fraud liability. Critical to the Fourth Circuit's holding was its conclusion that this Court has consistently interpreted section 10(b) "as proscribing only the deception, by material misrepresentation or omission, of a purchaser or seller of securities, or of a person in some way connected with or having a stake in an actual or proposed purchase or sale of securities." 58 F.3d at 949.

In Rubin v. United States, 449 U.S. 424, 429 n.6 (1981), this Court explicitly left open the question "whether misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves can form the basis of a violation of section 17(a)" of the 1933 Act. The same question remains open for section 10(b) of the 1934 Act, permitting circuit courts to reach conflicting interpretations. Compare Chemical Bank v. Arthur Anderson & Co., 726 F.2d 930, 943 (2d Cir.) (Friendly, J.) ("'misrepresentations or omissions involved in a securities transaction but not pertaining to the securities themselves'" cannot "form the basis of" a violation of section 10(b) and Rule 10b-5), cert. denied, 469 U.S. 884 (1984) (quoting Rubin v. United States, 449 U.S. 424, 429 n.6 (1981)) with S.E.C. v. Rana Research, Inc., 8 F.3d 1358, 1362 (9th Cir. 1993) ("Fraud touching the intrinsic value of securities and the means of accomplishing the purchase of securities

is sufficiently in connection with securities transactions to bring the fraud within section 10(b)."). And the court of appeals' evisceration of the "in connection" requirement in this case -- allowing a finding of deceit "in connection" with the purchase of EAS and Lopat shares to be based on a collateral fraud involving completely different stocks -- makes it an appropriate vehicle for the Court's clarification of the provision's scope.

The need for resolution of the circuit conflict created by the court of appeals' decision is especially pressing in view of the influence that a Second Circuit decision inevitably has in the development of securities law (absent an authoritative pronouncement by this Court). Under the rule the Circuit adopted here, any person buying thinly traded securities can be criminally charged with or civilly sued for securities fraud, based solely on allegations that he acquired his purchase money fraudulently -- through a fraud on someone, anywhere. Since the allegations of fraud will often not be capable of resolution without a trial, the Circuit's relaxation of the "in connection" requirement will only add to the number of garden-variety tort cases masquerading as securities litigation that clog up federal dockets in every district with significant commercial activity. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 742 (1975) (noting virtue of rule that allows meritless securities suits to be dismissed before trial); see also Central Bank of Denver v. First

Interstate Bank of Denver, 114 S. Ct. 1439, 1454 (1994).

2. Understandably choosing not to rely solely on the "connection" between K&C's alleged fraud on its clearing broker and K&C's purchases of EAS and Lopat with some of the proceeds of that fraud, the court of appeals also held that the defendants had breached a duty to the entire market to make a general disclosure of their deceit on Evans. (App., infra, A-17). This aspect of the court's decision disregards this Court's holdings in Chiarella v. United States, 445 U.S. 222 (1980), and other cases, and presents a clear conflict with the law in other circuits.

In Chiarella, this Court held that a trader's failure to disclosure relevant information to the market cannot violate section 10b and Rule 10b-5 unless it occurs in the context of a "fiduciary or other similar relation of trust and confidence." Id. at 228. As the Court explained:

> [O]ne who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them." ... Accordingly, a purchaser of stock who has no duty to a prospective seller because he is

> neither an insider nor a fiduciary has been held to have no obligation to reveal material facts.

Id. at 228-29 (footnotes and citations omitted); see Dirks v. S.E.C., 463 U.S. 646, 654-55 (1983). Other Circuits have properly understood Chiarella and its progeny to mean that "[t]he parties to an impersonal market transaction owe no duty of disclosure to one another absent a fiduciary or agency relationship, prior dealings, or circumstances such that one party has placed trust and confidence in the other." Paracor Finance, Inc v. General Electric Capital Corp., __ F.3d __ (9th Cir. 1996) (No. 94-15633); see United States v. Bryan, 58 F.3d 933, 947 (4th Cir. 1995); Deutschman v. Beneficial Corp., 841 F.2d 502, 506 (3rd Cir. 1988) ("[m]arket participants who are neither insiders not fiduciaries of another type need not disclose material facts"), cert. denied, 490 U.S. 1114 (1989); Roeder v. Alpha Industries, 814 F.2d 22, 27 (1st Cir. 1987) ("fraud on the market theory does not dispense with the requirement that there must be a duty to disclose before there can be liability").

In a futile effort to distinguish Chiarella, and this weight of authority, the court of appeals reasoned that "Chiarella ... addresses the obligations of one who seeks to benefit personally from non-public corporate information. It does not apply to those such as appellants who seek to benefit personally from an illegal, self-created scheme." (App., infra, A-17). This suggestion finds not a shred of support in Chiarella

or Dirks or the cases from other circuits following Chiarella.

The only authority that the court of appeals cited to support its reasoning was one of its own cases, United States v. Regan, 937 F.2d 823, 829 (2d Cir. 1991), cert. denied, 504 U.S. 940 (1992). Regan, in turn, relied on United States v. Charney, 537 F.2d 341, 350 (9th Cir.), cert. denied, 429 U.S. 1000 (1976), where, in dicta, the Ninth Circuit had noted: "'Failure to disclose that market prices are being artificially depressed operates as a deceit on the market place and is an omission of a material fact.'" 937 F.2d at 829 (quoting 537 F.2d at 351). A theory that stock purchases made in order to "depress" or "levitate" the market artificially are, by their very nature, "deceptive" does indeed support the court of appeals' conclusion that issues of "duty" need not be confronted in a manipulation case. But that was precisely the theory that this Court rejected in Schreiber. Indeed, during the trial of this case, the government felt bound to concede in summation that defendants would have been "playing by the rules" had their used their own money to "keep the supply of [Lopat and EAS stock] off the market [and] keep the price from falling." Tr. 4039 ; see Tr. 4045-46. Were courts able to find manipulation based on "non-disclosure" whenever a trader's motive was found to be "artificial" or not sufficiently related to his valuation of the stock, the vagueness and confusion that this Court sought to prevent in Schreiber would indeed come to pass.

In Chiarella, this Court specifically warned against excessive judicial activism in the securities area: "Formulation of ... a broad duty, which departs radically from the established doctrine that duty arises from a specific relationship between two parties, ... should not be undertaken absent some explicit evidence of congressional intent." 445 U.S. at 233. Yet the court of appeals engaged in just such a radical departure here. And given the Second Circuit's influence over the development of the law in this area, its decision threatens to open the floodgates of frivolous litigation, unrelated to the purposes of the securities laws, that this Court has endeavored to keep closed. See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 739 ("litigation under Rule 10b-5 presents a danger of vexatiousness different in degree and kind from that which accompanies litigation in general"); see also Central Bank of Denver v. First Interstate Bank of Denver, 114 S. Ct. at 1454.

3. Because the court of appeals' decision represents an radical and inappropriate expansion of the scope of criminal and civil liability under section 10(b) and Rule 10b-5, and because the decision is inconsistent with well-settled law in other circuits, this Court's review is warranted.

CONCLUSION

The petition for a writ of certiorari should be granted.

Respectfully submitted.

Daniel Richman, Esq.
140 West 62nd Street
New York, N.Y. 10023

APRIL 1996

UNITED STATES COURT OF APPEALS

FOR THE SECOND CIRCUIT

Nos. 372, 373, 374—August Term, 1995

(Argued October 27, 1995 Decided January 11, 1996)

Docket Nos. 95-1123, -1124, -1125

UNITED STATES OF AMERICA,

Appellee,

—v.—

PAUL RUSSO, BARBARA HOSMAN,
WILLIAM PETROKANSKY,

Defendants-Appellants.

Before:

FEINBERG, OAKES and CABRANES,
Circuit Judges.

Appeal from a judgment of the United States District Court for the Eastern District of New York (Johnson, *J.*), entered after a jury trial, convicting appellants of mail

fraud under 18 U.S.C. § 1341, securities fraud under 15 U.S.C. §§ 78j(b) and 78ff, and conspiracy to commit mail fraud and securities fraud under 18 U.S.C. § 371.

Affirmed.

DANIEL RICHMAN, New York, NY (James A. Cohen, Ian Weinstein, of counsel), *for Defendant-Appellant Hosman.*

TERENCE J. LYNAM, New York, NY (C. Fairley Spillman, Neil J. Welch, Jr., Akin, Gump, Strauss, Hauer & Feld, L.L.P., of counsel), *for Defendant-Appellant Russo.*

LAWRENCE S. BADER, New York, NY (Morvillo, Abramowitz, Grand, Iason & Silberberg, P.C., of counsel), *for Defendant-Appellant Petrokansky.*

ALAN B. VICKERY, Assistant United States Attorney, Brooklyn, NY (Zachary W. Carter, United States Attorney, Peter A. Norling, Gordon Mehler, Assistant United States Attorneys, of counsel), *for Appellee.*

OAKES, *Senior Circuit Judge*:

This is an appeal in a stock market manipulation case. Paul Russo, Barbara Hosman, and William Petrokansky appeal from judgments of conviction entered February 28, 1995, by the United States District Court for the

Eastern District of New York, Sterling Johnson, Jr., *J.*, after a jury found them guilty of mail fraud under 18 U.S.C. § 1341 and securities fraud under 15 U.S.C. §§ 78j(b) and 78ff. Russo and Hosman were also found guilty of conspiracy to commit mail fraud and securities fraud under 18 U.S.C. § 371. Russo was sentenced to 18 months' imprisonment, five years' probation, and restitution; Hosman was sentenced to five years' imprisonment with all but six months suspended and five years' probation; and Petrokansky was sentenced to 12 months' imprisonment and five years' probation. The appellants argue that the district court's instructions to the jury on several aspects of securities law were erroneous; that the district court improperly permitted testimony by the government's expert witness; that the evidence against Hosman and Petrokansky was insufficient to convict them; and that the government's rebuttal summation deprived them of a fair trial. We affirm.

BACKGROUND

As is typical in cases involving manipulation of stocks, the facts before us are extensive and detailed. For purposes of clarity, we divide them into three sections: the business framework, the manipulation scheme, and the trial. We consider all facts and inferences to be drawn from the evidence in the light most favorable to the government. *United States v. Birnbaum*, 373 F.2d 250, 252 (2d Cir.), *cert. denied*, 389 U.S. 837 (1967).

I. The Business Framework

All three defendants worked for Kureen & Cooper ("K&C") a broker-dealer which traded in small stocks

generally valued at under five dollars per share.[1] Russo bought K&C in 1985 after another small broker-dealer firm he co-owned, Creative Securities, went out of business due to insufficient minimum capital. Russo installed himself as president of K&C and oversaw its operations. Hosman, who had worked with Russo since 1962 and moved with him from Creative Securities, managed the K&C office for Russo and was a K&C broker. She also served as one of K&C's three directors starting in 1986. Petrokansky, who had also followed Russo from Creative Securities, was one of roughly 20 K&C brokers. Unlike the other brokers, however, Petrokansky had his own office and reported directly to Russo rather than to a manager.

As part of its business, K&C underwrote initial public offerings ("IPOs") of penny stocks, including the IPOs of the stocks at issue in this case: Lopat and EAS. Both Lopat and EAS were new high-risk companies from which K&C received substantial commissions for its underwritings as well as warrants entitling K&C to buy large numbers of shares at set prices after one year. These warrants served as an incentive to K&C to establish markets for Lopat and EAS so that the price of each company's shares would rise above the set warrant price. After handling the IPOs, K&C acted as the principal market maker for Lopat and EAS, holding itself out to the market as ready to buy and sell Lopat and EAS stocks at prices which it posted on NASDAQ.

K&C's customer accounts and its own trading accounts were handled by Evans & Co. ("Evans"), a larger brokerage firm that acted as a "clearing broker"

[1] These stocks are known on Wall Street as "penny stocks" and are traded over the counter through the National Association of Securities Dealers Automated Quotation system (NASDAQ).

for approximately ten small broker-dealers like K&C. Pursuant to a clearing agreement, Evans performed all the processing and administrative functions associated with K&C's trades. K&C would execute the trades by filling out buy and sell tickets, which were collected and processed by Evans at the end of each day. Evans would then send out confirmations and account statements to K&C's customers for whom trades had been executed and to K&C for trading in its own accounts. Evans also provided K&C with a daily "trading slate" that documented all the activity in K&C's account for the previous day.

II. The Manipulation Scheme

Despite the prospects for Lopat and EAS at the time of their IPOs, the stocks did not perform well. By August 1986, there were more customers selling Lopat and EAS to K&C than buying from the firm, putting K&C at risk of substantial losses. K&C was so thinly capitalized that if it bought stock, it had to sell most of it the same day in order to maintain the minimum net capital required by federal securities regulations. Given the low demand for Lopat and EAS, K&C feared that it would have to sell off the stock at reduced prices and risk triggering a snowball effect as more holders sold Lopat and EAS back to K&C before the price dropped further. K&C was therefore burdened with the problem of continuing to make a market for Lopat and EAS stock so as not to put itself out of business.

In response to this crisis, Russo came up with a complex scheme to manipulate Lopat and EAS stock so that much of it remained off the market and prices did not decline. The scheme involved both unauthorized placement of Lopat and EAS in customers' accounts and the

"parking" of Lopat and EAS stock in the accounts of K&C customers in exchange for guaranteed profits. The scheme also included a buy-up of Lopat and EAS that was financed with false credits in K&C's trading account generated through short sales of other stocks. Russo enlisted Hosman and Petrokansky to implement the scheme, directing Hosman to place the unauthorized trades and Petrokansky to park the stock. Russo directed another K&C employee, Paul Miano ("Miano"), who was the firm's head trader and cooperated with the government in the prosecution, to make the short sales.

A. The Unauthorized Placements

From August to October 1986, Hosman placed blocks of Lopat or EAS stock in K&C accounts without customers' authorization by presenting buy tickets to Miano. The stock would then be "sold" from K&C's account to the customer's account and K&C would receive credit for stock sold at the selling price quoted in NASDAQ. When the customer received confirmation of the sale and called to question it, he or she would be told that a mistake had been made. K&C, after prolonging payment by seeking a seven-day credit extension on behalf of the customer,[2] would either buy back the stock or cancel the original trade. Hosman would then frequently take the same block of stock and place it in another customer account without authorization.

These unauthorized trades kept large blocks of Lopat and EAS stock off the market and out of K&C's account for up to two weeks. K&C thus created an impression of

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[2] The Federal Reserve Board allows brokers to request extensions for payment for stock purchases from the New York Stock Exchange pursuant to Federal Reserve Board Regulation T, 12 C.F.R. § 220.8(d) (1995).

interest in the stock that did not exist while at the same time avoiding the need to sell Lopat and EAS on the open market at prices below its offer prices.

B. The Parking

During the same period that Hosman made unauthorized placements of stock, Petrokansky engaged in another method of "hiding" Lopat and EAS stock from the market. On instructions from Russo, Petrokansky placed Lopat or EAS with customers by guaranteeing them that K&C would buy the stock back in one or two weeks at a small profit of an eighth or sixteenth of a dollar per share. When the time came to buy back the stock, Petrokansky presented sell tickets reflecting a higher price than the customer had paid or than was posted on NASDAQ that day. Petrokansky would often immediately park the same stock with a new customer.

Parking Lopat and EAS stock accomplished the same purpose as making unauthorized placements: it kept Lopat and EAS off the market and out of K&C's account. In so doing, the parking created a false impression of Lopat's and EAS's vitality on the market and freed K&C from responsibility for the stock. Unlike the unauthorized placements, however, the parking bore a cost to K&C, namely, the profits it paid out to the customers who held the stock.

C. The Short Sales

In order to purchase and keep in inventory the Lopat and EAS shares that were being sold back by customers, as well as to finance the parking of Lopat and EAS stock, K&C needed a ready source of cash. The appellants found one when Russo inadvertently discovered that he could generate false cash credits from Evans in

K&C's trading account by making short sales of high-value stocks.

A short sale involves a seller agreeing to sell stock it does not own and then borrowing the stock from a broker to tender to its customer. The seller pays a fee while it borrows the stock and eventually must "cover" the short sale by returning an equivalent amount of stock to the broker. Short sales are closely regulated, and, according to the Federal Reserve Board margin rules, a seller is presently required to put up margin equal to at least 50% of the value of the stock it sells short. 12 C.F.R § 220.19(a) (1995). In addition, any proceeds from the sale are frozen under the rules until the seller covers the short sale.

Through an accounting error, Evans credited K&C's account for the short sales without freezing the proceeds to ensure coverage or demanding compliance with margin requirements. The mistake occurred because K&C did not notify Evans that it was making the sales, as required under the clearing agreement, and made them from its regular cash trading account rather than from a special margin account used for short sales, which K&C did not have.[3] The effect of the error was to give K&C an unrestricted cash credit in its account for each short sale it placed.

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[3] Evans had three types of trading accounts, designated Type 1, Type 2 and Type 3. Type 1 accounts were regular cash accounts in which Evans permitted brokerage firms to conduct short sales of penny stocks; Type 2 accounts were regular margin accounts; and Type 3 accounts were regular margin accounts through which brokerage firms made short sales of high-value stock. K&C did not have a Type 3 account with Evans nor did K&C's clearing agreement with Evans permit it to engage in short sales of high-value stocks. K&C did not have sufficient capital to put up the margin for such short sales as required by Federal Reserve margin regulations. *See* 12 C.F.R. § 220.19(a) (1995).

The appellants used the cash credits to pay for the increasing number of Lopat and EAS shares held in K&C's inventory. Russo authorized short sales so as to generate sufficient credit to offset the Lopat and EAS shares bought each day, eventually paying for over 400,000 shares of each through the false credits. The credits allowed K&C to keep in its inventory stock that otherwise would have been sold at a loss on the open market.

Together, the components of the manipulation scheme permitted K&C to balance out its trading account each day during the fall of 1986 while keeping large portions of Lopat and EAS off the market and creating an appearance of demand for the stock. The appellants used the components in tandem to keep K&C alive even though, if it had been acting honestly, the firm would have fallen below the minimum net capital requirements as early as September 1986. Because of the manipulation scheme, K&C did not close its doors until late December 1986. At that time, Evans had terminated the clearing agreement after discovering the fraudulent short sales and K&C's practice of applying for extensions in connection with its unauthorized trades, and K&C had insufficient net capital to operate. After closing K&C, the appellants opened a new securities firm in the same office less than two weeks later.

III. The Trial

The government brought a nineteen-count indictment against appellants in December of 1991: one count of conspiracy to manipulate stock in violation of 18 U.S.C. § 371 (1994), sixteen counts of mail fraud in violation of 18 U.S.C. § 1341 (1994), and two counts of securities fraud in violation of 15 U.S.C. §§ 78j(b) and 78ff (1994).

In the indictment, the government listed unauthorized placements, parking, and short sales as the three types of market manipulation engaged in by the appellants. The jury trial commenced on January 4, 1994.

At trial, the government relied on an expert witness, Howard Spindel ("Spindel"), to describe the breadth and impact of the manipulation scheme. Spindel testified about K&C's trading patterns, using charts and lists of stock movement to demonstrate how Lopat and EAS were kept off the market through unauthorized trades and parking. He also testified about the extent to which the false credits generated by short sales affected K&C's inventory of Lopat and EAS stock. Spindel gave an expert opinion that the prices of Lopat and EAS shares would have significantly declined had K&C allowed the manipulated stock to reach the market.

The government's evidence on the price movements of Lopat and EAS stock during and after the manipulation scheme reinforced Spindel's conclusion. During the scheme, the price of Lopat remained flat at approximately three dollars per share while the price of EAS dropped gradually from one dollar and 19 cents per share to just under 94 cents. Two weeks after the scheme ended, the price of Lopat had dropped 42% and the price of EAS 59%, resulting in a loss of roughly four million dollars in the combined value of the outstanding shares. The prices continued to drop through the first months of 1987 even though Evans had taken over K&C's accounts and continued to hold most of the stock off the market. By the end of May 1987, the price of Lopat had fallen to $1.25 per share and EAS stood at 40 cents.

After two and a half months of trial, the jury returned its verdict on March 16, 1994, finding Russo and Hosman guilty on all counts and Petrokansky guilty on five

counts of mail fraud and two counts of securities fraud. A mistrial was declared as to the remaining counts against Petrokansky.

In this appeal, appellants seek reversal of their convictions on eight grounds: (1) that the district court erred in instructing the jury that it was permitted to convict for stock manipulation based on the fraudulent short sales; (2) that the district court inadequately instructed the jury on appellants' defense to the short sale scheme; (3) that the district court erred in admitting the expert testimony of Spindel; (4) that the district court erred in refusing to instruct the jury on the definition of stock parking; (5) that the district court erred in its instruction to the jury on artificial price levels; (6) that the evidence was insufficient to convict Hosman of conspiracy; (7) that the evidence was insufficient to convict Petrokansky of mail fraud; and (8) that the prosecutor's rebuttal summation was improper.

DISCUSSION

I. The Short Sales Charge

The appellants' objection to the jury instructions on short sales is in essence an objection to the legal theory advanced by the government. They contend that the short sales cannot serve as a basis for their convictions for conspiracy because those sales were not manipulative within the meaning of the law. Under the same rationale, they argue that their convictions for the substantive counts of securities fraud and mail fraud must be reversed. Because the jury instructions permitted conviction on any of the three types of manipulation charged by the government, including the short sales, the

appellants argue that the instructions were erroneous. Given the substance of their argument, it is not necessary for us to examine the content or sufficiency of the instructions themselves. We instead turn our attention to whether the short sales theory of manipulation is well-grounded in law. As our inquiry involves a question of law, we review under a *de novo* standard. *United States v. Brown*, 52 F.3d 415, 420 (2d Cir. 1995), *petition for cert. filed*, Sept. 7, 1995 (No. 95-5913).

Section 10(b) of the Securities Exchange Act prohibits the use "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe . . . ." 15 U.S.C. § 78j(b) (1994). Section 10(b) is implemented by Rule 10b-5, the regulation at issue here:

> **Employment of manipulative and deceptive devices.**
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,

in connection with the purchase or sale of any security.

17 C.F.R. § 240.10b-5 (1995).

The appellants advance a complex series of arguments regarding why their practice of short selling high-value stocks to generate false credits did not violate Rule 10b-5. Upon careful examination, however, their claim boils down to a simple assertion: the fraudulent short sales were not sufficiently connected to K&C's purchases of Lopat and EAS stock to be considered part of the manipulation scheme. Because the short sales only deceived Evans and not those trading in Lopat and EAS, the appellants contend, the sales cannot be a manipulative device within the meaning of Rule 10b-5.

In response, the government argues (1) that the short sales were driven by K&C's need to purchase Lopat and EAS in order to keep the stock off the market; (2) that there was a close correlation on any given day between the credit amount generated from the short sales and the number of Lopat and EAS shares purchased by K&C; and (3) that the short sales were used in concert with the unauthorized placements and parking of Lopat and EAS stock. Taken together, these facts are more than adequate, in the government's view, to meet Rule 10b-5's "in connection with" requirement. Under this construction, the use by K&C of ill-gotten funds to keep Lopat and EAS off the market deceived investors as to the true value of the stock and enabled K&C to manipulate the market. The government therefore contends that the short sale scheme was properly charged as a manipulative device in violation of Rule 10b-5.

We are thus confronted with two interpretations of Rule 10b-5's "in connection with" requirement, one nar-

row and one broad. Although a review of the case law yields neither direct precedent nor a comparable set of facts to those presented here, we are not without guidance in deciding which interpretation to adopt. The law of the Supreme Court and this circuit regarding the scope of 10b-5 is extensive and supports the government's position.

The Supreme Court has interpreted Section 10(b) and Rule 10b-5 expansively in accordance with congressional intent to minimize fraud in securities trading. As stated by the Court in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 151 (1972), "[t]hese proscriptions, by statute and rule, are broad and . . . are obviously meant to be inclusive." The purpose of the Section and its implementing regulations is to prevent fraud, whether it is "a garden type variety of fraud, or present[s] a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *Superintendent of Ins. v. Bankers Life & Casualty Co.*, 404 U.S. 6, 11 n.7 (1971) (quoting *A.T. Brod & Co. v. Perlow*, 375 F.2d 393, 397 (2d Cir. 1967)); *see also Chiarella v. United States*, 445 U.S. 222, 226 (1980) ("Section 10(b) was designed as a catchall clause to prevent fraudulent practices."); *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 203 (1976) (Section 10(b) "enable[s] the Commission 'to deal with new manipulative [or cunning] devices.' ") (quoting Hearings on H.R. 7852 and H.R. 8720 before the House Committee on Interstate and Foreign Commerce, 73rd Cong., 2d Sess., 115 (1934)). The Court has also held that Section 10(b) and Rule 10b-5:

> embrace a 'fundamental purpose . . . to substitute a philosophy of full disclosure for the philosophy of

> *caveat emptor* and thus to achieve a high standard of business ethics in the securities industry'.

Affiliated Ute Citizens, 406 U.S. at 151 (quoting *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 186 (1963)); *see also Basic Inc. v. Levinson*, 485 U.S. 224, 234 (1988).

In *Superintendent of Insurance*, the Court applied its expansive approach in holding that Section 10(b) "must be read flexibly, not technically and restrictively." 404 U.S. at 12. This case examined the "in connection with" language of Rule 10b-5 and held that a company which had been bought through the fraudulent conversion of its own assets by an outside party had a cause of action for deceptive practices under Rule 10b-5. *Id.* at 12-13. The Court rejected a narrower reading of "in connection with" proposed by the lower court in favor of an interpretation that asked whether the deceptive practices "touch[ ]" sales of securities. *Id.*

This circuit has followed the Supreme Court's approach to Rule 10b-5 and its "in connection with" requirement. In *In Re Ames Dep't Stores Inc. Stock Litigation*, 991 F.2d 953 (2d Cir. 1993), the court noted that its previous narrow view of this language had been repudiated by the Supreme Court in *Superintendent of Insurance*. *Id.* at 964-66. The court also stated that although many of the cases which followed *Superintendent of Insurance* involved difficult determinations of Rule 10b-5's boundaries, frauds which "mislead[ ] the general public as to the market value of securities" and "affect the 'integrity of the securities markets,' as this court described them in *Superintendent of Ins.*, 430 F.2d at 361, fall well within the Rule." *Id.* at 966. Although in *Ames* it was the company itself which had deceived the

public about the value of its stock, the general proposition that "fraud can be committed by any means of disseminating false information into the market on which a reasonable investor would rely," *id.* at 967; *see also Basic Inc.*, 485 U.S. at 246, is no less true when the deception is worked by the stock's market maker, as in the instant case.

As noted above, the government presented substantial evidence of the short sales' integral role in the scheme to manipulate Lopat and EAS stock. In essence, the appellants were running a stock-kiting scheme in which they moved stock from account to account in order to create the appearance of market activity. While the short sales did not affect the markets for Lopat and EAS through actual trading, they enabled K&C to create a false impression of demand for the stock and to shield prices from the realities of the market. Without the money generated through the short sales, the appellants would not have been able to keep large blocks of Lopat and EAS off the market or finance the other elements of the kiting scheme, thereby misleading the public as to the value of Lopat and EAS stock. As this court said in *Ames*:

> [i]f such a straightforward cause and effect is not a connection, then the Rule would not punish a particularly effective means of reducing the integrity of, and public confidence in, the securities markets.

991 F.2d at 967.

The appellants seek to distinguish the *Ames* case by asserting that K&C's fraudulent short sales could not have affected the trading decisions of Lopat and EAS investors because K&C made its purchases of Lopat and EAS stock on the open market. They analogize their practice to that of an investor who lied on his home loan

application in order to get more money to buy stock. We find this analogy inapposite. K&C was the market maker for Lopat and EAS stock—there was no "open market" on which it could trade except for the one it created, and it could not have continued to make this market without the money generated by the short sales. Unlike the unscrupulous investor to whom the appellants unfortunately compare themselves, K&C could not separate its fraud from its purchase of Lopat and EAS stock.

The appellants make a similar mistake in arguing that they had no duty to disclose their deceit to the market and that therefore the short sales cannot be considered part of the manipulation scheme. Relying on *Chiarella*, they contend that the duty to disclose arises "because of a fiduciary or other similar relation of trust and confidence," 445 U.S. at 228 (quoting the Restatement (2d) of Torts § 551(2)(a) (1976)), that was not present in this case. *Chiarella*, however, addresses the obligations of one who seeks to benefit personally from non-public corporate information. It does not apply to those such as the appellants who seek to benefit personally from an *illegal*, self-created scheme. We drew this exact distinction in *United States v. Regan*, 937 F.2d 823, 829 (2d Cir.), *amended* 946 F.2d 188 (2d Cir. 1991), *and cert. denied*, 504 U.S. 940 (1992), holding that a broker who failed to disclose its depression of market prices in the absence of a fiduciary duty could not rely on *Chiarella* because it had been charged with market manipulation, not insider trading.

Given the weight of the case law and our mandate to interpret Rule 10b-5 expansively, we conclude that the fraudulent short sales made for the express purpose of financing the appellants' stock kiting scheme served as a fraud on the market for Lopat and EAS stock. We

therefore find that the short sales were sufficiently connected to the manipulation scheme as to constitute a violation of Section 10(b) and Rule 10b-5, and that the jury was properly instructed on the conspiracy, securities fraud, and mail fraud counts.

II. The Defense Theory Regarding the Short Sales

The appellants argue that the district court, in declining to give two of their proposed instructions, failed to instruct the jury adequately on their defense to the short sales charge. The absence of the instructions, appellants claim, prevented a balanced presentation of the defense's theory of the case. We review the propriety of the district court's instructions *de novo*. *United States v. Dove*, 916 F.2d 41, 45 (2d Cir. 1990).

The appellants' theory was that the short sales did not deceive Evans, and therefore were not fraudulent, because the sales were done openly with Evans' knowledge. The instructions proposed by the appellants read in pertinent part:

> The defendants contend that Evans was aware that Kureen & Cooper was selling short in the trading account and that Evans knew that it was giving immediate cash credit to Kureen & Cooper for the short sales . . . . The defendants further contend that the trade tickets for the short sales were not miscoded and were not deceptive.

The district court denied these instructions and instead instructed the jury in the following manner:

> The defendants [ ] contend that the government has failed to prove beyond a reasonable doubt that they agreed to defraud Evans & Co. of money by deceiving Evans & Co. through short sales . . . . if you

> find that the government has failed to prove beyond a reasonable doubt that Evans & Co. was deceived by short selling in the trading account, you may not convict on the conspiracy charge based on the alleged scheme to defraud Evans & Co. Additionally, if you agree with the defendants' contention, you may not find that the defendants artificially affected the price of EAS and Lopat stock based solely on purchases of stock from money generated from the short sales.

The appellants characterize this instruction as "boilerplate" language which did not convey the essence of their case.

The appellants bear the burden of demonstrating that their proposed instructions "accurately represented the law in every respect." *Dove*, 916 F.2d at 45. We find that they have not met this burden because their proposed instructions would have misled the jury about the degree of deceit perpetrated against Evans.

First, while K&C's trades were included in Evans' computer-generated records, Evans cannot be said to have had true awareness of K&C's practice or to have approved of it. K&C's short sales of high-value stocks were clearly not legitimate—they occurred in a cash account without K&C ever putting up the required margins for such sales. The very fact that K&C stumbled onto the false credits by making a coding mistake on a sell ticket, and then failed to notify Evans about the mistake, indicates that the practice was not above-board. Moreover, Evans ended its relationship with K&C as soon as it became fully aware of the short sales and the generated credits. Thus, the appellants' proposed instruction on Evans' knowledge of the short sales and

credits would have presented the jury with a false picture of K&C's fraudulent activity.

Second, an instruction on the coding of trading tickets, as requested by the appellants, would have led the jury down the wrong path in determining whether fraud had been perpetrated against Evans. The issue was not whether the tickets were miscoded,[4] but rather that K&C had made short sales of high-value stocks from a cash account without sufficient margin and in violation of its clearing agreement with Evans. The appellants' proposed instructions would therefore have misled the jury into thinking that if the tickets were not miscoded, the appellants had a valid defense to the charge of fraud.

We also cannot agree with the appellants that the district court's instruction failed to adequately inform the jury of the defense theory that Evans was not deceived by the short sales. A defendant is entitled to a jury instruction on a defense theory "for which there is any foundation in the evidence," *United States v. Alfonso-Perez*, 535 F.2d 1362, 1365 (2d Cir. 1976) (citations omitted), but he is not entitled to have the exact language he proposes read to the jury. *United States v. Dyman*, 739 F.2d 762, 771 (2d Cir. 1984), *cert. denied*, 469 U.S. 1193 (1985). The trial court enjoys broad discretion in crafting its instructions which is only "circumscribed by the requirement that the charge be fair to both sides." *United States v. GAF Corp.*, 928 F.2d 1253, 1263 (2d Cir. 1991). In this case, the district court

[4] However, we find specious the appellants' argument that short sales could be made out of Type 1 cash accounts as well as Type 3 credit accounts and that therefore K&C's tickets were not miscoded. While short sales of penny stocks for which K&C was the market maker were permissible in its Type 1 account, short sales in high-value stocks required a Type 3 credit account, which K&C did not have under the clearing agreement with Evans.

clearly stated that the jury could not find the appellants guilty of conspiracy to commit fraud through the short sales unless they found that Evans was deceived. This instruction fairly apprised the jury of the essence of the defense theory and resulted in no prejudice to the appellants.

III. Definition of "Parking"

The appellants next contend that the government changed its definition of stock "parking" throughout the case, creating a confusion that the District Court should have remedied through a jury instruction. They argue that the failure to give such an instruction deprived them of a fair trial in numerous ways, including permitting the jury to convict on an erroneous definition and denying a valid theory of defense.

While we recognize that the government was not wholly consistent in describing the conduct that constitutes stock parking, we find the appellants' arguments unavailing. As an initial matter, we do not believe the government's definition of "parking" varied sufficiently to confuse the jury or mislead the defense. Although the words used to describe "parking" changed during the course of trial, the essential concept behind the government's theory of manipulation remained constant: K&C perpetrated a fraud on the market by divorcing the financial risk of owning Lopat and EAS from legal ownership of the stock. The evidence presented by the government fully supported this theory of manipulation and presented a clear picture of stock parking to the jury.

Moreover, we agree with the government that "parking," as used in this prosecution, is not a legal term requiring jury explanation. Rather, it is a business term

that describes conduct which may or may not rise to the level of a 10b-5 violation. Unlike the concepts of "agent" and "guilt," which are offered by the appellants as examples of terms which require jury instruction, "parking" is not defined by an established set of legal criteria.[5] "Parking" was simply used by the government as a means to describe some of the fraudulent activities of the appellants and requires no more guidance to the jury than other factual allegations. Thus, the district court did not err in refusing to give an instruction on the definition of "parking."

Finally, we note that the appellants' proposed instruction on parking, which focused on voting rights and alienability as indicia of stock ownership, would have diverted the attention of the jury to questions of little significance to the charge of stock manipulation. The issue in this case was whether the appellants manipulated the price of Lopat and EAS stock, not whether the customers with whom K&C parked stock could have sold it or voted it during the parking period. An instruction focusing on the technicalities of stock ownership would therefore have confused, if not misled, the jury, and the district court properly avoided this result by denying the appellants' request.

Because the term "parking" was defined by various witnesses during the course of the trial and was otherwise used in a comprehensible manner, we find that a jury instruction defining the term was not necessary and

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[5] The Fifth Circuit has noted that "[t]he better practice would be to instruct the jury on the meaning of all terms of operative significance." *United States v. Anderton*, 629 F.2d 1044, 1049 n.5 (5th Cir. 1980). While that may be a worthy aspiration, it is evidently not the law of this circuit as appellants cite no Second Circuit cases for the proposition that all significant terms must be defined in instructions to the jury and we find none.

that the appellants were not deprived of their right to a fair trial by the absence of such an instruction.

IV. Instruction on Artificial Price

The district court instructed the jury on artificial price in the following fashion:

> In order to find an intent to manipulate the price of EAS and Lopat stock, you must find that the defendant you are considering intended to raise the price of the stock to, or maintain the price of the stock at an artificial level, that is, to *a level above the investment value of the stock as determined by available information and market forces* (emphasis added).

The appellants objected to this instruction, proposing instead a definition of artificial price that required proof of the defendants' belief that the stock was really worth less than the price at which they traded it. They now claim that the district court's failure to give their proposed instruction deprived them of their right to a fair trial.

The appellants attempt to convince us that their subjective valuation of Lopat and EAS stock, i.e., what they believed to be the stocks' true worth, should have been the sole determinant of whether the prices that resulted from their fraudulent activities were "artificial." This argument finds neither support in the law—indeed, they cite none—nor in the facts of this case. It is clear that the appellants did not believe that Lopat and EAS were undervalued: the government established in numerous ways that the appellants were motivated by an intent to subvert the operation of normal market forces on the price of the stock rather than by legitimate investment

concerns. Furthermore, the jury was repeatedly told by the district court in other instructions that it must find *fraudulent* conduct in order to convict the appellants. We therefore conclude that the appellants were not prejudiced by the district court's instruction on artificial price.

V. Expert Testimony

The appellants argue that the district court improperly admitted the testimony of Howard Spindel, the government's expert witness. They claim that Spindel was not qualified to testify as an expert in the area of stock pricing and had no factual basis for his testimony about the impact of unauthorized trades and parking of stock on the prices of Lopat and EAS. The appellants also contend that Spindel drew legal conclusions about the defendants' state of mind in relation to the parking transactions.

We find little merit in the appellants' arguments. First, the trial court has "broad discretion . . . to determine the qualifications of witnesses [which] will not be disturbed unless its ruling was manifestly erroneous." *Eagleston v. Guido*, 41 F.3d 865, 874 (2d Cir. 1994), *cert. denied*, __ U.S. __, 116 S.Ct. 53 (1995) (quoting *McCullock v. H.B. Fuller Co.*, 981 F.2d 656, 657 (2d Cir. 1992)). In light of Spindel's extensive experience in the securities market as a consultant, a general securities principal, and the controller of a large options trading firm, as well as his expertise on the net capital rule, we see no error, manifest or otherwise, in the district court's decision to admit him as an expert. With regard to the second claim, a review of the record demonstrates that Spindel's testimony about the impact of the appellants' trades and parks on the price of Lopat and EAS stock

had an adequate basis in fact. Spindel provided numerous price charts and lists of stock movement that supported his statements about Lopat and EAS. Furthermore, his testimony "provid[ed] the groundwork in the form of an opinion to enable the jury to make its own informed determination." *United States v. Duncan*, 42 F.3d 97, 101 (2d Cir. 1994).

As to the appellants' third contention, we have noted that "[p]articularly in complex cases involving the securities industry, expert testimony may help a jury understand unfamiliar terms and concepts." *United States v. Bilzerian*, 926 F.2d 1285, 1294 (2d Cir.), *cert. denied*, 502 U.S. 813 (1991). But we have also cautioned that expert testimony must not usurp the roles of judge and jury by offering legal conclusions. *Id.* The appellants argue that Spindel's opinion on whether certain transactions were parking transactions involved the legal conclusion that the appellants intended to park stock. For support, they cite *United States v. Scop*, 846 F.2d 135, 139-40, *modified*, 856 F.2d 5 (2d Cir. 1988), a securities fraud case where the expert improperly used specific statutory and regulatory language such as "manipulation" and "scheme to defraud" to describe the defendants' actions.

In *Scop*, however, we stated that had the expert "merely testified that controlled buying and selling of the kind alleged here can create artificial price levels . . . , no sustainable objection could have been made." *Id.* at 140. We find that Spindel's testimony fits this hypothetical because it focused solely on factual conclusions and did not involve any legal characterizations. Spindel gave no opinion as to whether the appellants had violated the securities laws and did not make any statements about their intent; he simply described certain

stock transactions and his opinion of their effect on the market. We conclude, therefore, that the district court properly exercised its discretion in admitting the expert testimony.

VI. Sufficiency of the Evidence

The appellants claim that the evidence was not sufficient to convict Hosman of conspiracy or Petrokansky of mail fraud. We recently set out our approach to challenges of sufficiency of the evidence in *United States v. Martinez*:

> It is well settled that a defendant seeking to overturn a conviction based upon insufficiency of the evidence bears a "heavy burden." Not only must the evidence be viewed in the light most favorable to the government and all permissible inferences drawn in its favor, but if the evidence, thus construed, suffices to convince any rational trier of fact of the defendant's guilt beyond a reasonable doubt, then [the] conviction must stand. The government's case need not exclude "every possible hypothesis of innocence," and it is the task of the jury, not the court, to choose among competing inferences. Moreover, the jury's verdict may be based entirely on circumstantial evidence.

54 F.3d 1040, 1042-43 (2d Cir.), *cert. denied*, __ U.S. __, 64 U.S.L.W. 3379 (1995) (citations omitted).

Under this standard, we find that the evidence was sufficient to convict both Hosman and Petrokansky. The government presented ample evidence of Hosman's participation in the conspiracy to manipulate Lopat and EAS stock, including her conducting of unauthorized trades, her involvement in the liquidation of K&C, her

role in the management of K&C, and her knowledge of K&C's trading activity. Similarly, the government showed Petrokansky's intent to manipulate the stocks as required by the mail fraud statute, providing evidence of his payout for participating in the scheme, his special relationship with Russo, and his knowledge of Lopat's and EAS's artificially inflated prices. We therefore conclude that neither Hosman nor Petrokansky meet the "heavy burden" of demonstrating insufficiency.

VII. Prosecution's Rebuttal Summation

The appellants claim that the government's rebuttal summation violated Federal Rule of Criminal Procedure 29.1[6] by introducing new matters to which the defense could not respond. Specifically, they object to the prosecutor's handwritten additions to a chart already in evidence and his allegedly abusive remarks about the defense. Upon review of the record, we find that the prosecution's references to the defense need no discussion as they were relatively mild, like his remark that the defense was "trying to take the heat off their clients," and clearly harmless. *Compare United States v. Biasucci*, 786 F.2d 504, 514 n.9 (2d Cir.), *cert. denied* 479 U.S. 827 (1986) (where prosecutor called defense counsel "sleaze" and "you hypocritical son of a bitch"). The issue of the introduction of new matters, however, does warrant our attention.

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6 Rule 29.1 addresses the order of closing arguments. The 1974 Advisory Committee Note states:

> The rule is drafted in the view that the fair and effective administration of justice is best served if the defendant knows the arguments actually made by the prosecution in behalf of conviction before the defendant is faced with the decision whether to reply and what to reply.

In his rebuttal summation, the prosecutor added a column of numbers to a chart introduced at trial which purported to summarize the commissions paid to Miano as a broker at K&C. He then used these new numbers to demonstrate that Miano testified truthfully about the commissions, matching the amount of Miano's adjusted net commissions shown on the existing chart with the new numbers reflecting payments made to Miano by Russo. The comparison of these amounts undermined the defense's accusation that Miano had lied about receiving the commissions due to another K&C broker. Although Miano's credibility and the amount of his commissions had been challenged by the defense in its summation, the prosecutor took a step beyond the existing evidence to create a new line of argument based on Russo's payments to Miano. We therefore cannot adopt the government's characterization of the additional numbers as "simple arithmetic" in response to a door opened by the defense.

Instead, we find the prosecutor's actions to be similar to those taken in *United States v. Gleason*, 616 F.2d 2, 25 (2d Cir. 1979), *cert. denied*, 444 U.S. 1082 (1980), where a prosecutor produced a new tabulation during his rebuttal. In that case, we found the prosecutor's behavior improper, despite the argument that the tabulation was in response to the defense's summation and based on exhibits already in evidence, because it effectively introduced "a new theory . . . at almost literally the last minute of a long trial." *Id.* at 26. Here, the prosecution's re-organization of the numbers relating to Miano's commissions created a similar "last minute" argument and was therefore improper.

A finding of impropriety, however, does not end our inquiry. As stated by the Supreme Court in *United States v. Young*, 470 U.S. 1, 11 (1985):

> a criminal conviction is not to be lightly overturned on the basis of the prosecutor's comments standing alone, for the statements or conduct must be viewed in context; only by so doing can it be determined whether the prosecutor's conduct affected the fairness of the trial.

Whether the prosecutor's improper conduct requires reversal in this case depends on whether the conduct substantially prejudiced the appellants so as to deny them a fair trial. *United States v. Tutino*, 883 F.2d 1125, 1136 (2d Cir. 1989), *cert. denied*, 493 U.S. 1081 (1990). We assess the degree of prejudice through "three factors: the severity of the misconduct; the measures adopted to cure the misconduct; and the certainty of conviction absent the improper statements." *United States v. Modica*, 663 F.2d 1173, 1181 (2d Cir. 1981), *cert. denied*, 456 U.S. 989 (1982). Applying these factors, we conclude that the appellants were not substantially prejudiced in this case.

First, the introduction of a new chart column based on information already in the record does not strike us as severe misconduct, both because it represented a limited segment of the two and one-half hour rebuttal summation and because it did not reflect an ongoing pattern of disregard for appropriate conduct at trial. *See Modica*, 663 F.2d at 1181 (noting that four improper remarks made in rebuttal were aberrational misconduct that did not demand reversal). Second, while the district court did not take any direct measures to cure the effects of the prosecutor's remarks, it did reiterate to the jury on

several occasions that a lawyer's comments could not be considered evidence. Finally, and most persuasively, we believe the case against the appellants to be sufficiently strong without the improper comments and the new chart column. Indeed, the new column related to statements of a government witness whose credibility the jury was entrusted to determine, not to any actions of the appellants themselves. These improprieties came after eleven weeks of trial during which substantial evidence was presented incriminating the appellants, and it is highly unlikely that the prosecutor's misconduct had a decisive role in the appellants' conviction.

Because the appellants were not substantially prejudiced by the improper conduct of the prosecutor in his rebuttal summation, we hold that the misconduct was harmless error which cannot sustain a reversal of the convictions in this case.

CONCLUSION

We have considered all of the appellants' arguments in support of reversal of their convictions and find them unpersuasive. The judgment of the district court is therefore affirmed.

Supreme Court, U.S.
FILED
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No. 95-1966

In the Supreme Court of the United States

OCTOBER TERM, 1995

PAUL RUSSO, ET AL., PETITIONERS

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

WALTER DELLINGER
Acting Solicitor General
JOHN C. KEENEY
Acting Assistant Attorney General
JOEL GERSHOWITZ
Attorney
Department of Justice
Washington, D.C. 20530
(202) 514-2217

RICHARD H. WALKER
General Counsel
PAUL GONSON
Solicitor
JACOB H. STILLMAN
Associate General Counsel
ERIC SUMMERGRAD
Principal Assistant General Counsel
MARK PENNINGTON
Senior Litigation Counsel
Securities and Exchange Commission
Washington, D.C. 20549

20 pp

QUESTION PRESENTED

Whether petitioners' scheme to deceive public investors by buying and holding large blocks of certain stocks so as to create an appearance of active trading in those stocks and thereby prop up their market price, financed by false cash credits generated through fraudulent short sales of other securities, constituted illegal securities manipulation, in violation of Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5.

TABLE OF CONTENTS

	Page
Opinion below	1
Jurisdiction	1
Statement	1
Argument	7
Conclusion	16

TABLE OF AUTHORITIES

Cases:

Alabama Farm Bureau Mut. Cas. Co. v. *American Fidelity Life Ins. Co.*, 606 F.2d 602 (5th Cir. 1979), cert. denied, 449 U.S.. 820 (1980)	10
Angelastro v. *Prudential-Bache Securities Inc.*, 764 F.2d 939 (3d Cir.), cert. denied, 474 U.S. 935 (1985)	14
Basic Inc. v. *Levinson*, 485 U.S. 224 (1988)	15
Chemical Bank v. *Arthur Anderson & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984)	13
Chiarella v. *United States*, 445 U.S. 222 (1980)	7, 15
Ernst & Ernst v. *Hochfelder*, 425 U.S. 185 (1976)	8
Gurwara v. *Lyphomed, Inc.*, 937 F.2d 380 (7th Cir. 1991)	12
Halsey, Stuart & Co., 30 S.E.C. 106 (1949)	9
Hunt v. *Robinson*, 852 F.2d 786 (4th Cir. 1988)	12-13
Landy v. *FDIC*, 486 F.2d 139 (3d Cir. 1973), cert. denied, 416 U.S. 960 (1974)	10
Pagel, Inc. v. *SEC*, 803 F.2d 942 (8th Cir. 1986)	10
Santa Fe Industries, Inc. v. *Green*, 430 U.S. 462 (1977)	9, 15-16
Schlick v. *Penn-Dixie Cement Corp.*, 507 F.2d 374 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975)	10
Schreiber v. *Burlington Northern, Inc.*, 472 U.S. 1 (1985)	8-9, 15

Cases—Continued: Page

Scott v. *Brown, Doering, McNab & Co.*, [1892] 2 Q.B. 724 (Eng. C.A.) 9
Superintendent of Insurance v. *Bankers Life & Casualty Co.*, 404 U.S. 6 (1971) 12, 13-14
United States v. *Charnay*, 537 F.2d 341 (9th Cir.), cert. denied, 429 U.S. 1000 (1976) 10
United States v. *Naftalin*, 441 U.S. 768 (1979) 4, 12
United States v. *O'Hagan*, Nos. 94-3856 & 94-3714, 1996 WL 431180 (8th Cir. Aug. 2, 1996) 14
Wisniewski v. *United States*, 353 U.S. 901 (1957) ... 13

Statutes and regulations:

Securities Exchange Act of 1934, 15 U.S.C. 78a *et seq.*:
15 U.S.C. 78b 8
15 U.S.C. 78b(3) 8
15 U.S.C. 78ff 2
15 U.S.C. 78j(b) (§ 10(b)) 2, 6, 8, 11, 12, 13, 14
18 U.S.C. 371 1
18 U.S.C. 1341 2
12 C.F.R. 220.19(a) 5
17 C.F.R. 240.10b-5 (Rule 10b-5) 6, 8, 9, 10, 13

Miscellaneous:

Adolph A. Berle, Jr., *Liability for Stock Market Manipulation*, 31 Colum. L. Rev. 264 (1931) 9

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BRIEF FOR THE UNITED STATES IN OPPOSITION

OPINION BELOW

The opinion of the court of appeals (Pet. App. A1-A30) is reported at 74 F.3d 1383.

JURISDICTION

The judgment of the court of appeals was entered on January 11, 1996. The petition for a writ of certiorari was filed on April 8, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

After a jury trial in the United States District Court for the Eastern District of New York, petitioners Russo and Hosman were each convicted on one count of conspiracy to commit securities fraud, in violation of 18 U.S.C. 371, 16 counts of mail fraud, in

violation of 18 U.S.C. 1341, and two counts of securities fraud, in violation of 15 U.S.C. 78j(b) and 78ff. Petitioner Petrokansky was convicted on five counts of mail fraud, in violation of 18 U.S.C. 1341, and two counts of securities fraud, in violation of 15 U.S.C. 78j(b) and 78ff.[1] Russo was sentenced to 18 months' imprisonment, to be followed by five years' probation, and was ordered to make restitution in an amount yet to be determined. Hosman was sentenced to five years' imprisonment (with all but six months suspended), to be followed by five years' probation. Petrokansky was sentenced to 12 months' imprisonment, to be followed by five years' probation. Pet. App. A2-A3, A9-A11.

1. Russo was the owner and president of Kureen & Cooper (K&C), a penny stock broker-dealer that he acquired after another broker-dealer firm that he owned went out of business due to insufficient minimum capital. Hosman was a long-time Russo associate who had moved to K&C from Russo's previous firm. She served as a K&C director, managed the K&C office, and worked as a K&C broker. Petrokansky also came to K&C from Russo's previous firm. He was one of roughly twenty stock salesmen working at K&C but, unlike the other salespeople, he had his own office and reported directly to Russo rather than to the manager in charge of the brokers. Pet. App. A3-A4.

The charges against petitioners arose from their scheme to manipulate the market price of the securities of two start-up companies, Lopat Industries, Inc. (Lopat), and E.A.S. Technologies, Inc. (EAS). K&C

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[1] A mistrial was declared as to the remaining counts against Petrokansky. Pet. App. A11.

had underwritten the initial public offerings of both companies and, as part of its compensation, had received warrants entitling it to buy large numbers of the companies' shares at predetermined prices after one year. The warrants gave K&C an incentive to establish markets for the stocks so that the price of the companies' shares might rise above the exercise prices set by the warrants. Once trading began, K&C acted as the principal market maker for both companies' securities in the over-the-counter market, holding itself out as ready to buy and sell Lopat and EAS stocks at prices posted on the National Association of Securities Dealer Automated Quotation system. Pet. App. A-4, A-17.

The companies' stocks did not perform well. By August 1986, there were more customers seeking to sell the stocks than to buy them. K&C was itself so thinly capitalized, moreover, that it had to sell whatever shares it took in as market maker by the end of each day in order to maintain the minimum net capital required by the Securities and Exchange Commission's broker-dealer regulations. Given the low demand for the companies' securities, K&C was faced with the prospect of having to sell off the shares that it acquired each day at reduced prices, which would further reduce their market value. To forestall that possibility, petitioners embarked on a scheme, from July through December, 1986, to purchase and hold large blocks of Lopat and EAS stock in order to create the false impression that the stocks were being actively traded by the public and among other dealers, and thereby prop up the stocks' market prices. Pet. App. A5-A6.

As charged, petitioners' scheme had three deceptive components:

a. Acting on Russo's instructions, Hosman placed blocks of the companies' stocks, totalling hundreds of thousands of shares, in K&C customer accounts without the customers' authorization, which made it seem as though the stocks were more actively traded than they were. When a customer discovered the improper placement, K&C would take the shares back (often simply to place them in another customer's account), but during the term of their improper placement the shares were off the market, which reduced further erosion in their market prices. Pet. App. A6-A7.

b. Also on Russo's instructions, Petrokansky placed substantial blocks of the companies' stocks with certain customers on the understanding that K&C would buy the shares back in a week or two at a guaranteed small profit to the customer. Like the unauthorized placements, "parking" the stocks with K&C customers had the effect of taking large quantities of shares off the market. Pet. App. A7.

c. Russo obtained the means to finance K&C's substantial purchases of Lopat and EAS stocks, and to pay a profit margin to those with whom K&C parked blocks of the companies' shares, by making fraudulent short sales of other securities to its clearing firm, Evans, Inc. Pet. App. A7-A9.[2] Securities and Ex-

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[2] A short sale is a sale of stock that the seller does not own. At the time of the sale, the seller delivers borrowed stock. Eventually, the seller must "cover" the sale by purchasing stock to return the shares it has borrowed. A short seller profits from any interim decline in the market price of the stock, capturing the difference between the original sale price and the cover price. *United States* v. *Naftalin*, 441 U.S. 768, 770 (1979).

change Commission (SEC) regulations require a short seller to put up a margin equal to at least 50% of the value of the stock sold, and require that any proceeds from the short sale be frozen until the seller has covered its position. 12 C.F.R. 220.19(a). Russo became aware, however, that, because of a glitch in Evans' accounting system, so long as K&C did not notify Evans (as it was required to do by the clearing agreement) that the sales it was making were short sales, Evans would immediately credit K&C's account with the proceeds of those sales, without requiring the posting of margin or waiting until the position was covered. Pet. App. A8. By effecting short sales without notice to Evans, K&C was therefore able to receive an unrestricted cash credit in its account for each short sale made. *Ibid.* Russo ultimately used those cash credits to finance K&C's acquisition of more than 800,000 shares of Lopat and EAS stock—thus keeping in K&C's inventory a large volume of stocks that would otherwise have been sold at a loss on the open market—and to pay the profit margins promised to K&C customers for parking the companies' shares. *Id.* at A9.

The three components of petitioners' scheme thus operated together to permit K&C to balance out its trading account each day during the fall of 1986 while at the same time artificially boosting the price of the companies' stocks. Pet. App. A9. In December 1986, however, Evans discovered the improper short selling and cancelled its clearing agreement with K&C. *Ibid.* When petitioners' scheme collapsed, the prices of the

stocks plummeted,[3] and K&C went out of business. *Ibid.*[4]

2. The court of appeals rejected (Pet. App. A11-A18) petitioners' argument that the fraudulent short sales were insufficiently connected to K&C's purchases of Lopat and EAS stocks to be considered part of petitioners' manipulative scheme under Section 10(b) of the Securities Exchange Act of 1934 (Exchange Act), 15 U.S.C. 78j(b), and Rule 10b-5, 17 C.F.R. 240.10b-5.[5] The court explained that petitioners had operated a "stock-kiting scheme," in which they moved the companies' stocks from account to account to create the appearance of an active market. Pet. App. A16. While their fraudulent short sales did not affect the markets for the stocks through actual trading,

> they enabled K&C to create a false impression of demand for the stock and to shield prices from the

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[3] Within two weeks, the price of Lopat and EAS shares dropped 42% and 59%, respectively, resulting in a loss of roughly $4 million in the combined value of the outstanding shares, and the prices continued to drop throughout the Spring of 1987. Pet. App. A10.

[4] Petitioners opened a new securities firm in the same office less than two weeks later. Pet. App. A10.

[5] Section 10(b) prohibits the use "in connection with the purchase or sale[ ] of any security" of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe." 15 U.S.C. 78j(b). Rule 10b-5, promulgated pursuant to Section 10(b), declares it unlawful (a) "to employ any device, scheme, or artifice to defraud," (b) to make material misrepresentations or misleading omissions, or (c) "to engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security." 17 C.F.R. 240.10b-5.

> realities of the market. Without the money generated through the short sales, [petitioners] would not have been able to keep large blocks of Lopat and EAS off the market or finance the other elements of the kiting scheme, thereby misleading the public as to the value of Lopat and EAS stock.

Ibid. The court concluded that, unlike "an investor who lie[s] on a home loan application in order to get more money to buy stock," K&C could not, as the market maker, separate its fraudulent short sales from its purchases of Lopat and EAS stock. *Id.* at A16-A17.

The court of appeals also rejected (Pet. App. A17) petitioners' argument that their fraudulent short sales could not be considered part of the stock manipulation scheme absent proof that they breached an independent duty (arising from a fiduciary or similar relationship) to disclose their deceit to those in the market. In the court's view, petitioners' nondisclosure theory derived no support from *Chiarella* v. *United States*, 445 U.S. 222 (1980), because *Chiarella* was concerned with those who seek to benefit personally from insider trading, not with those, like petitioners, who seek to benefit from active manipulation of the market. Pet. App. A17.[6]

ARGUMENT

The court of appeals correctly affirmed petitioners' convictions under the facts of this case, and its decision does not conflict with any decision of this

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[6] The court also rejected a number of other challenges to petitioners' convictions, none of which is raised in the petition.

Court or of any other court of appeals. No further review is warranted.

1. Contrary to petitioners' argument (Pet. 20), stock purchases made for the purpose of artificially manipulating the market are a form of fraud actionable under the securities laws. Congress passed the Exchange Act in order to "insure the maintenance of fair and honest markets" in securities transactions. 15 U.S.C. 78b. Schemes to affect market prices were of particular concern, because, as Congress recognized, "the prices of securities on [securities] exchanges and [over-the-counter] markets [we]re susceptible to manipulation and control." 15 U.S.C. 78b(3). Section 10(b) of the Exchange Act thus prohibits the use, "in connection with the purchase or sale of any security," of "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the [SEC] may prescribe." 15 U.S.C. 78j(b). It is implemented by Rule 10b-5, which, among other things, declares it unlawful, "in connection with the purchase or sale of any security," for any person to "employ any device, scheme, or artifice to defraud" or "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person." 17 C.F.R. 240.10b-5.

As used in Section 10(b), "manipulative" is a term of art that "connotes intentional or willful conduct designed to deceive or defraud investors by controlling or artificially affecting the price of securities." *Schreiber* v. *Burlington Northern, Inc.*, 472 U.S. 1, 6 (1985), quoting *Ernst & Ernst* v. *Hochfelder*, 425 U.S. 185, 199 (1976) (emphasis omitted). "The term refers generally to practices, such as wash sales, matched orders, or rigged prices, that are

intended to mislead investors by artificially affecting market activity." *Schreiber*, 472 U.S. at 6, quoting *Santa Fe Industries, Inc.* v. *Green*, 430 U.S. 462, 476-477 (1977). It is understood to encompass "the full range of ingenious devices that might be used to manipulate securities prices." *Schreiber*, 472 U.S. at 7, quoting *Green*, 430 U.S. at 477.

Unlawful manipulation is not limited to misleading statements, but also includes conduct intended fraudulently to influence the market price of securities. As Lord Lopes observed more than one hundred years ago, with regard to securities fraud, there is "no substantial distinction between false rumours and false and fictitious acts." *Scott* v. *Brown, Doering, McNab & Co.*, [1892] 2 Q.B. 724, 730 (Eng. C.A.) (quoted approvingly in *Schreiber*, 472 U.S. at 7 n.4). Indeed, "the highest type of representation which can be made to the market is the representation contained in the published report of a sale," because a reported sale price "constitutes an open representation to the market of an appraisal at which one party has been willing to sell and another party willing to buy; it promptly becomes an element of every subsequent appraisal, at least for a period of time." Adolph A. Berle, Jr., *Liability for Stock Market Manipulation*, 31 Colum. L. Rev. 264, 270-271 (1931). It has thus long been recognized that stock trades made without verbal misrepresentations, but executed for the purpose of manipulating the stock price, are a form of actionable fraud.[7]

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[7] See *Halsey, Stuart & Co.*, 30 S.E.C. 106, 112 (1949) (trades made for the purpose of manipulating stock prices are prohibited by Rule 10b-5, because their effect "is to distort the character of the market as a reflection of the combined judg-

Petitioners' actions fall squarely within that category of prohibited conduct. Over the course of nearly six months, petitioners operated what the court of appeals aptly described as a stock-kiting scheme. In the guise of making a market, petitioners bought Lopat and EAS stocks into K&C's inventory in order to create the false appearance of substantial market demand and, at the same time, reduce the supply of those stocks on the market. Because K&C could not afford to hold the stocks, and could not sell them without causing the market price to collapse, petitioners made unauthorized placements of shares into its customers' accounts and parked blocks of shares in other customers' accounts, constantly shuffling the stocks among various accounts to escape detection. Their fraudulent short sales of other securities generated the cash credits that petitioners needed to acquire the stocks and to pay the customers' parking commissions. The purpose and effect of petitioners' scheme was to deceive investors as to the true market value of Lopat and EAS securities. The magnitude of their deception was illustrated by the fact that, when petitioners found

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ments of buyers and sellers, and to make of it a stage managed performance."); see also, *e.g.*, *Pagel, Inc.* v. *SEC*, 803 F.2d 942, 945-946 (8th Cir. 1986); *Alabama Farm Bureau Mut. Cas. Co.* v. *American Fidelity Life Ins. Co.*, 606 F.2d 602, 611-613 (5th Cir. 1979), cert. denied, 449 U.S. 820 (1980); *United States* v. *Charnay*, 537 F.2d 341, 347-351 (9th Cir.), cert. denied, 429 U.S. 1000 (1976); *Schlick* v. *Penn-Dixie Cement Corp.*, 507 F.2d 374, 379 (2d Cir. 1974), cert. denied, 421 U.S. 976 (1975). See also *Landy* v. *FDIC*, 486 F.2d 139, 161 (3d Cir. 1973) ("scheme deliberately calculated to manipulate the market value of a stock" is covered by Rule 10b-5), cert. denied, 416 U.S. 960 (1974).

themselves unable to continue the scheme, the market price of the companies' stocks fell by more than 40%. Pet. App. A10.

2. Petitioners contend (Pet. 9-18) that the short sales, though fraudulent, were not effected "in connection with" the manipulative purchases so as to implicate Section 10(b), and that, since there is a possibility that the short sales were the only deceptive conduct found by the jury, their convictions must be reversed. They argue (Pet. 8-9) that the court of appeals' interpretation of Section 10(b) exposes all securities traders to liability "whenever their open-market purchases are said to be funded by any fraud on anyone in any context." That argument is without merit.

a. The court of appeals' decision, which turned on the special facts presented by petitioners' scheme, was correct on those facts, and in no sense suggests that "any fraud" by a securities purchaser "in any context" is a sufficient basis for conviction of securities fraud. The court was careful to explain that it was not merely the fact that K&C's purchases happened to be funded by the proceeds of the short sales that rendered the short sales sufficiently "in connection with" the manipulative scheme. The decision below turned on the fact that the short sales were an integral part of a multi-faceted scheme by the principal market maker to deceive investors as to the value of Lopat and EAS stocks. Through petitioners' actions, K&C used one part of its business as a securities dealer (the fraudulent short selling) to operate another part of its business (maintenance of a market for the manipulated securities). Because K&C was the principal, indeed the dominant, market maker in Lopat and EAS stock, "there was no 'open market' on

which [K&C] could trade except for the one it created, and it could not have continued to make this market without the money generated by the short sales." Pet. App. A17.

Investors have the right, when they trade in securities, to expect that the market is a real one, not a sham fabricated by the market maker through artificial trades made with false cash credits. In this case, investors who traded in the manipulated stocks were injured "as a result of deceptive practices touching [on their purchase or] sale of [the securities]," and that satisfies the "in connection with" requirement. See *Superintendent of Insurance* v. *Bankers Life & Casualty Co.*, 404 U.S. 6, 12-13 (1971).[8]

b. Contrary to petitioners' argument (Pet. 11-13), the decision in this case does not conflict with the decisions of other courts of appeals concerning the scope of the "in connection with" requirement. None of the purportedly conflicting cases cited by petitioners involved facts analogous to those here. *Gurwara* v. *Lyphomed, Inc.*, 937 F.2d 380 (7th Cir. 1991), concerned a misrepresentation by an employer that stock options it had granted an employee would not be affected by a change in his employment status. The court held that the misrepresentation was not actionable under Section 10(b), because "the misrepresentation went only to [the employee's] opportunity to purchase the stock at the described price" and was "in

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[8] The indictment, moreover, independently charged that petitioners Russo and Hosman conspired to deceive Evans through the short selling, in violation of the mail fraud statute. See *Naftalin*, 441 U.S. at 772-777 (fraud against a broker-dealer by its customer is a violation of the federal securities laws).

no way related to the value of that stock." *Id.* at 382-383. *Hunt* v. *Robinson*, 852 F.2d 786 (4th Cir. 1988), involved a claim by an employee that his employer fraudulently refused to convey to him stock that he had been promised in consideration for his labor. The court found that the alleged fraud was outside the scope of the securities laws, because it lay "not in the actual sale of the stock, but in defendants' refusal to tender the shares as required by the terms of the contract." *Id.* at 787. *Chemical Bank* v. *Arthur Anderson & Co.*, 726 F.2d 930 (2d Cir.), cert. denied, 469 U.S. 884 (1984), concerned a loan that had been extended on the basis of fraudulent financial statements submitted by the borrower. Although the loan was secured in part by stock of the borrower's subsidiary, no misrepresentations had been made with regard to the pledged stock, and the court held that the fraudulent financial statements were not sufficiently related to the pledge to bring the pledge within Rule 10b-5. *Id.* at 943.[9]

In contrast to those cases, in this case petitioners' fraudulent short sales were directly related to their scheme to manipulate the market price of securities. K&C's acquisition of large blocks of Lopat and EAS stocks with false cash credits generated by the unauthorized short sales was designed to create a false impression of a robust and healthy market for the shares—and thus to deceive participants in the market for securities (the very persons Section 10(b) was enacted to protect). Cf. *Bankers Life*, 404 U.S.

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[9] Even if there were tension between the decision in *Chemical Bank* and the decision in this case, a conflict within a court of appeals is properly resolved by that court. *Wisniewski* v. *United States*, 353 U.S. 901, 902 (1957) (per curiam).

at 6, 9 (misrepresentation respecting value of consideration paid for stock is a form of securities fraud).[10]

c. Petitioners claim (Pet. 15-16) that this case reflects a "general tendency" on the part of the Second Circuit to give a broad construction to Section 10(b)'s "in connection with" requirement. They contend that review should be granted here in light of disagreement in the circuits with respect to the validity of the misappropriation theory of insider trading, which also involves the scope of the "in connection with" requirement. See *United States* v. *O'Hagan*, Nos. 94-3856 & 94-3714, 1996 WL 431180 (8th Cir. Aug. 2, 1996) (finding the misappropriation theory invalid; discussing cases). The issues in those cases are (i) whether actionable misappropriation requires proof of deceptive conduct, and (ii) whether, when the person to whom a fiduciary duty not to trade on inside information is owed is neither the issuer nor a party to the transaction, a breach of that duty is, as Section 10(b) requires, "in connection with the purchase or sale" of securities. Those issues are not implicated here, because petitioners unquestionably engaged in deceptive conduct, and their victims indisputably included traders in the manipulated stocks. The validity of the misappropriation theory of insider trading has no bearing on the circumstances presented in this case.

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[10] Although petitioners also cite *Angelastro* v. *Prudential-Bache Securities Inc.*, 764 F.2d 939 (3d Cir.), cert. denied, 474 U.S. 935 (1985), in that case the court affirmed the district court's finding that misrepresentations by a broker-dealer concerning the interest charged on a margin account constituted fraud in connection with the purchase or sale of securities, even though the misrepresentations did not relate to the value of the security or the consideration offered for it. *Id.* at 944.

3. Contrary to petitioners' argument (Pet. 18), the court of appeals did not hold that petitioners "breached a duty to the entire market to make a general disclosure of their deceit on Evans." Rather, the court correctly rejected petitioners' claim that, in addition to proving petitioners' implementation of a scheme to artificially maintain the market price of Lopat and EAS stocks, the government was required to prove that petitioners breached a fiduciary or similar duty to those in the market by failing to disclose their unlawful manipulation.

Proof of an independent duty to disclose is required in prosecutions, like that in *Chiarella*, that are based on a defendant's failure to disclose non-public information on which he has traded. Petitioners' convictions were based on an entirely different form of misrepresentation—artificial trading designed to deceive public investors into believing that the demand for and the market price of the stocks were higher than they actually were. Petitioners' scheme entailed a failure to disclose their manipulative conduct,[11] but petitioners' "false and fictitious acts" of manipulation (*Schreiber*, 472 U.S. at 7 n.4) were the core of the scheme and the basis of petitioners' convictions. Regardless of whether a person has a relationship that gives rise to a duty to make disclosure, he has a duty not to engage in affirmative acts of deception. See *Basic Inc.* v. *Levinson*, 485 U.S. 224, 240 n.18 (1988) (even those who have no duty to disclose are "under the ever-present duty not to mislead"); *Green*, 430 U.S. at 476 ("manipulation" includes "practices, such as wash sales, matched

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[11] "Indeed, nondisclosure is usually essential to the success of a manipulative scheme." *Schreiber*, 472 U.S. at 7.

orders, *or rigged prices*, that are intended to mislead investors by artificially affecting market activity") (emphasis added).

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

WALTER DELLINGER
Acting Solicitor General

JOHN C. KEENEY
Acting Assistant Attorney General

JOEL GERSHOWITZ
Attorney

RICHARD H. WALKER
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

ERIC SUMMERGRAD
Principal Assistant General Counsel

MARK PENNINGTON
Senior Litigation Counsel
Securities and Exchange Commission

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